Weekly Commentary

12 March 2018

Late fade

This week sees the release of the December quarter national accounts, the last major piece of economic information from 2017. We expect the figures to highlight that the New Zealand economy, while still growing, has lost some momentum over the last year.

We estimate that GDP grew by 0.6% in the December quarter. That result would bring growth over the 2017 calendar year down to 2.9%, compared to 4% growth in 2016. Population growth was similar in both years – around 2% – so this represents a substantial softening in per-capita growth.

We recognise that this week's release is not the final word on the economy's performance. A year ago, the GDP figures appeared to be saying the same thing: that growth had been strong in previous years, but more recently had slowed to barely above zero in per-capita terms. However, at the end of last year Stats NZ published revisions to the recent history of GDP, incorporating better-quality information from annual surveys. The new figures told a different story: growth had in fact remained strong, reaching its peak in 2016.

The figures for 2017 have yet to be subjected to the annual revisions process. But the reported slowdown in GDP growth matches with what else we saw going on in the economy last year – which wasn't always the case in 2016.

Firstly, the housing market was much more subdued in 2017, following a couple of years of double-digit house price gains. That flowed through into people's willingness to spend, with the rate of growth in card spending slowing over the course of the year. Secondly, construction activity flattened out last year as the building industry faced constraints on capacity and access to finance. Finally, business confidence fell over the course of 2017 – a move that began even before the new Government was formed in October.

Coming into this year, a slower starting point for the economy will present challenges for policy makers. Lower than expected GDP could translate into a lower tax take (though so far tax revenue has continued to surprise to the upside of the Treasury's forecasts). It also raises questions about the economy's ability to absorb the impact of the Government's policy changes, such as those around labour laws and housing market speculation. For the Reserve Bank, lower than expected growth would mean that the rise of home-grown inflation pressures would be delayed even further.

GDP (15 March)

Previously we were forecasting a 0.8% rise in the production measure of GDP. However, we have revised this down to 0.6%, as the last of the sectoral indicators that were published last week were softer than we expected on balance.

Building work put in place rose by 1.4% in the December quarter, a little less than our forecast. Activity continues to slow in Canterbury as the earthquake rebuild work winds down, but it is trending higher in the rest of the country. Residential building work was flat for the quarter, while non-residential building rose. We've also assumed that other construction (not covered by the building work survey) will retrace to some extent after a 9% jump in the previous quarter.

The manufacturing survey initially appeared to be positive, with a 1% rise in sales volumes. The main factor was a 17% surge in petroleum manufacturing – but this is not the

Late fade continued

measure used to calculate GDP. The manufacturing survey is based on deflated sales; this can be unreliable when oil prices move sharply, as they did in the December quarter. For measuring GDP in this industry, Stats NZ surveys production volumes directly from the major players. It's unlikely that actual volumes rose to such a degree, given that refining capacity is limited.

The remaining details in the manufacturing survey were soft on balance. Manufacturing of machinery fell back after a strong rise in the September quarter, and there were either declines or small gains in wood products, metals and minerals. Food processing was mixed, with fruit and meat up, but dairy and beverages down.

Goods turnover was relatively brisk in the December quarter, with some of the strongest gains seen in the retail, wholesale and transport sectors. However, growth in personal and business services was more subdued. The poor dairying season continued, although milk collections didn't fall short by as much as they did in the September quarter.

The expenditure measure of GDP is considered to be less reliable as a measure of quarterly growth, but the details are sometimes of interest. For the December quarter, we expect to see solid growth in household spending and business investment, but with much of the growth being serviced by imports. In particular, there was a surge in imports of plant and machinery in the December quarter (which continued into early 2018). These imports have increased the trade deficit for now, but they will add to the economy's productive capacity over time.

Current account (14 March)

The surge in imports of capital equipment will contribute to an expected widening of the current account deficit over the year to December. We expect a deficit of 2.6% of GDP, from a revised 2.5% in September.

For the December quarter, the surge in imports overshadowed a modest rise in export volumes, leading to an increase in the goods trade deficit. Trade in services remained strongly in surplus, with growth in tourist numbers both into and out of the country.

The current account deficit remains well within what we would consider a sustainable range. That is, a deficit of less than 3-4% will stabilise or even reduce New Zealand's net overseas debt position, relative to GDP.

Indeed, it's remarkable that the deficit has remained at historically low levels throughout the economy's upturn. Low global interest rates have played a major part in keeping the country's net interest costs down. Stronger returns from export sectors such as tourism have also played a role.

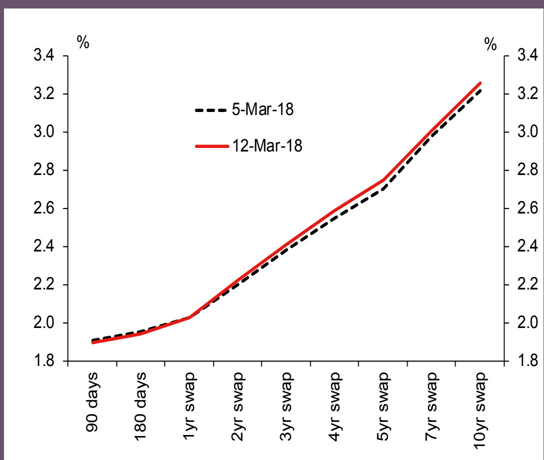
But perhaps the most significant factor is that we haven't seen a repeat of the surge in domestic demand – largely fuelled by offshore borrowing – that characterised the economic boom of the 2000s. Increased regulation and greater caution since the Global Financial Crisis have constrained the growth in overseas borrowing, contributing to a slower but arguably more sustainable economic upswing this time around.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Feb house sales and prices

Due the week starting 12 March, Sales last: -2.0%, Prices last; +3.4%yr

- January's REINZ housing market data was a little softer than the preceding three months. However, housing market data can be choppy on a month-to-month basis, particularly around the holiday season. In addition, monthly sales figures tend to get revised higher over time. We we still think that the housing market best characterised as enjoying a bit of a resurgence at present, following a drop in mortgage rates in late-2017 and the passing of the election. With fixed mortgage rates falling further in recent weeks, and the Reserve Bank slightly easing its LVR mortgage lending restrictions, we expect the current market buoyancy to continue for a few more months. However, later this year we expect fixed mortgage rates to start increasing, and the Government's policy program of cooling the housing market will bear on the market.

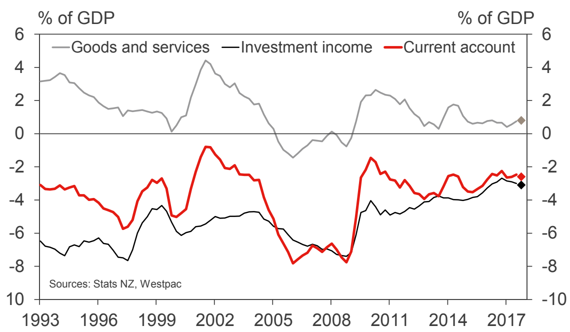
REINZ house prices and sales

NZ Q4 current account, % of GDP

Mar 14, Last: -2.5%, Westpac f/c: -2.6%

- We estimate that the annual current account deficit widened slightly to 2.6% of GDP.
- In seasonally adjusted terms, the goods trade deficit is expected to have widened by about half a billion dollars in the December quarter. A modest rise in export volumes was overshadowed by a surge in import volumes, led by imports of capital equipment and vehicles (including two more Boeings for Air New Zealand's fleet).
- The services surplus was broadly unchanged in the December quarter. There was strong growth in tourist numbers both into and out of the country.
- We expect a slight narrowing of the investment income deficit for the December quarter, with a pullback in profits of overseas-owned firms after a few unusually strong quarters.

Annual current account balance

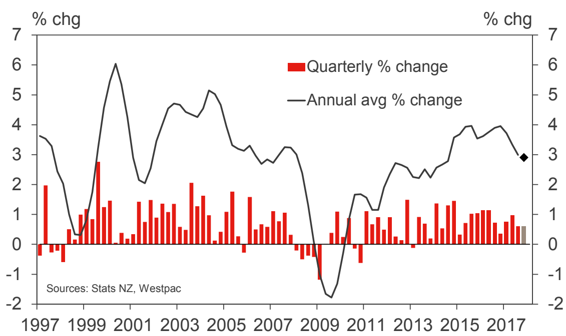


NZ Q4 GDP

Mar 15, Last: 0.8%, Westpac f/c: 0.6%, Mkt f/c: 0.6%

- We expect a 0.6% rise in the production measure of GDP. That compares to an average growth rate of 0.8% over the previous three quarters of 2017. With population growth still running strong at about 0.5% a quarter, this would mark the second quarter when growth has been barely above zero in per capita terms.
- There are no obvious one-off factors driving the quarterly result, just modest growth across a range of sectors. Retail and wholesale turnover were relatively brisk, but the services sectors were generally subdued, milk production fell, and the construction sector faced constraints on growth.
- For the year as a whole, we expect the growth rate to slow to 2.9%, compared to a peak of 4% growth in 2016.

Production-based GDP

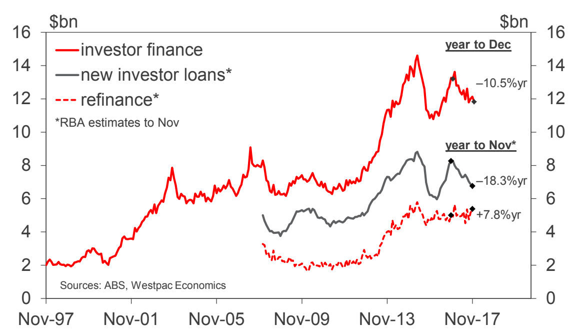


Aus Jan housing finance (no.)

Mar 13, Last: –2.3%, WBC f/c: –1.0%
Mkt f/c: -0.2%, Range: -1.5% to 1.0%

- Australian housing finance approvals posted a soft finish to 2017, the number of approvals for owner occupiers dipping 2.3%. Approvals ex refi were down 3.4%mth but still up 2.1%yr. The value of housing finance approvals to investors also posted a decline, down 2.6% to be 10.5% lower for the year with a notably sharper fall in NSW.
- Industry figures suggest Jan was another soft month for owner occupier approvals – we expect a 1.0% decline. As always, housing data should be treated with extra caution around the summer holiday low period as seasonal adjustment can amplify monthly volatility.

Value of investor finance approvals



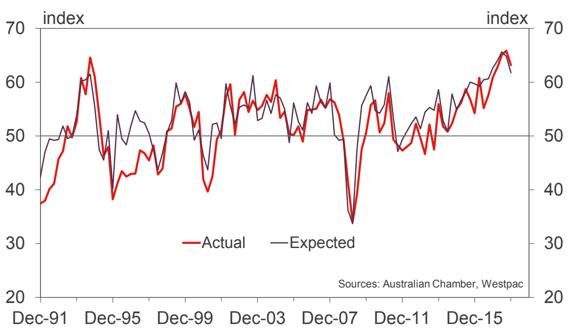
The week ahead

Aus Q1 Aus Chamber-Westpac survey of Industrial Trends

Mar 13, Last: 63.4

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Actual Composite tracks a range of demand related measures including investment and employment. The Q1 survey was conducted during February and the start of March. In Q4, the Actual Composite moderated to 63.4 from 66.1 in Q3, after a rebound from a dip in June 2015 to 55.1. Strength is centred on a lift in new orders and output as well as increased overtime and an uplift in employment. Manufacturing is benefitting from a rise in public infrastructure, non-mining business investment, and stronger world growth combined with a relatively low AUD. However, moderate consumption constrained by low wage growth and intensity from offshore competition are headwinds.

Westpac-AusChamber Composite indexes

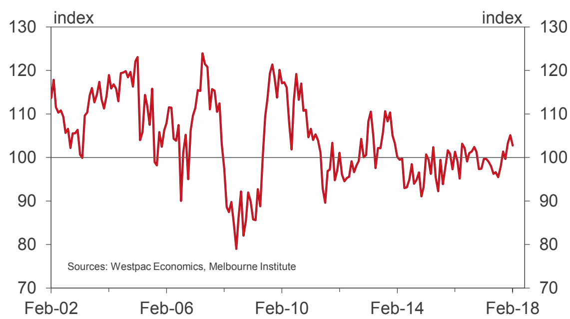


Aus Mar Westpac-MI Consumer Sentiment

Mar 14 Last: 102.7

- The Westpac-Melbourne Institute Consumer Sentiment Index fell by 2.3% to 102.7 in Feb from 105.1 in Jan. The Feb survey was conducted amid a wave of volatility across global financial markets. Under the circumstances, the slight fall in sentiment is a decent result, particularly given that it leaves the index in net optimistic territory above the 100 mark for a fourth consecutive month – a run that follows a twelve month stretch in which pessimists were in the ascendency for all but one month.
- The March survey is in the field over the week ended March 10. Financial markets have settled down somewhat, the ASX200 up over 2% since the Feb survey. The global backdrop remains unsettled though with increasing trade tensions. Further signs of house price declines locally are also likely to weigh on sentiment.

Consumer Sentiment Index

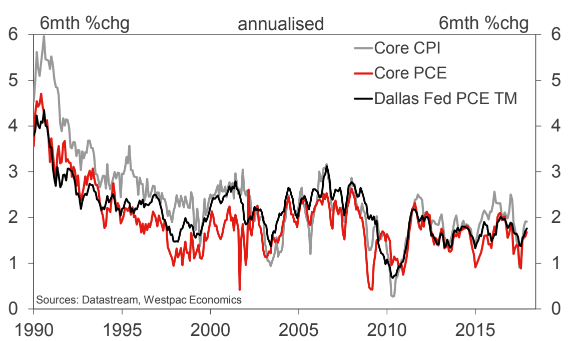


US Feb CPI

Mar 13, last 0.5%, WBC f/c 0.3%

- The January headline monthly outcome of 0.5% was the strongest since early 2013 and materially above target if annualised. That said, a similar gain a year ago dropped out of the annual growth calculation, leaving it unchanged at 2.1%yr. A large contributor to inflation in the month, and indeed over the past six, was energy prices. In January, the energy index rose 3.0% as gasoline prices gained 5.7%.That said, a noticeable acceleration in core inflation (ex food and energy) has also been evident. Having recorded a 1.1% annualised gain in the six months to July 2017, core inflation has since accelerated to a 2.6% pace. Come February, energy won't be a key contributor, but core pressures will remain, resulting in a price gain circa 0.3%.

Core inflation tending toward target

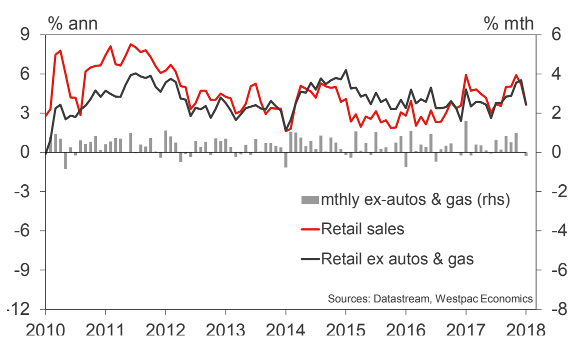


US Feb retail sales

Mar 14, last -0.3%, WBC f/c 0.4%

- Retail sales were a major disappointment in January, recording the weakest outcome in 11 months as households cut back on auto purchases and building materials. A downward revision was also made to the December outcome, exaggerating the weakness. It is worth noting that, excluding these more volatile items, core retail sales were also soft, a flat outcome in January following a revised 0.2% decline in December. Coming at a time of strong confidence and employment growth, the outcomes jar with the market's strong narrative. Come February, we anticipate spending will pick up. However, at less than 5% annualised, it is an outcome best regarded as solid not strong. For consumption to accelerate further, wage inflation will have to strengthen across the economy and confidence hold up.

Retail sales growth



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	Feb REINZ house prices, %yr	3.4%	–	–	Due this week. Lower rates & easing in lending restrictions…
	Feb REINZ house sales	2.7%	–	–	…supporting prices, but turnover softer than a year ago.
US	Feb monthly budget statement $bn	-192	-223	-	Deficit to see greater focus in 2018.
	Feb NFIB small business optimism	106.9	107.1	–	Very positive on activity and investment.
Tue 13					
NZ	Feb food price index	1.2%	–	0.3%	Risk to upside after storms ruined summer crops again.
	RBNZ Speak	–	–	–	Governor Grant Spencer to speak on macro-prudential policy
Aus	RBA speak	–	–	–	Assistant Governor Bullock, payments conf. Syd 11:10 am.
	Jan housing finance	-2.3%	-0.2%	–1.0%	Another soft month although figures less reliable in January.
	Q1 AusChamber-Westpac survey	63.4	–	–	Manufacturing sector optimistic.
	Feb NAB business survey	19	–	–	Conditions above avg levels, but Jan obs'n looks too high.
US	Feb CPI	0.5%	0.2%	0.3%	Energy not a factor in Feb, but core pressures remain.
Wed 14					
NZ	Q4 current account (% of GDP)	–2.6%	–2.6%	–2.6%	Well contained despite a surge in imports over the quarter.
Aus	RBA speak	–	–	–	Assistant Governor Kent, KangaNews Summit, Syd 9:05 am.
	Mar Westpac-MI Consumer Sentiment	102.7	–	–	Feb survey conducted in midst of financial market sell-off.
Chn	Feb retail sales YTD %yr	10.2%	9.8%	–	Consumer spending to continue growing at robust pace.
	Feb industrial production	6.6%	6.2%	–	LNY to dampen growth.
	Feb fixed asset investment ytd %yr	7.2%	7.0%	–	Private and public both slowing. LNY also at play.
Eur	Jan industrial production	0.4%	-0.2%	–	Consumer goods prod. positive of late.
	ECB President Draghi speaking	–	–	–	At ECB Watcher conference in Frankfurt.
US	Feb PPI	0.4%	0.1%	–	Broadly flat absent energy boost.
	Feb retail sales	-0.3%	0.3%	0.4%	Expected to bounce back after disappointing Jan.
	Jan business inventories	0.4%	0.6%	–	Stocks likely to add to growth in Q1.
Can	Feb Teranet/National Bank HPI	0.3%	–	–	Housing market has cooled, esp. Vancouver and Toronto.
Thu 15					
NZ	Q4 GDP	0.6%	0.7%	0.6%	The NZ economy's growth momentum slowed over 2017.
US	Mar Fed Empire state index	13.1	15	–	Remains at elevated level.
	Feb import price index	1.0%	0.3%	–	Weaker USD has been supportive of late.
	Initial jobless claims	231k	–	–	Above expectations last week; still very low.
	Mar Phily Fed index	25.8	23.0	–	Remains at elevated level.
	Mar NAHB housing market index	72	72	–	Very strong despite rising interest rates.
Fri 16					
NZ	Mar BusinessNZ manufacturing PMI	55.6	–	–	Points to easing in momentum c/f 2017 despite bounce.
Aus	RBA speak	–	–	–	Deputy Governor Debelle, Financial Risk Day, Syd 9:45am.
Jpn	Jan industrial production final	-6.6%	–	–	Preliminary showed a sharp drop.
Eur	Feb CPI %yr final	1.3%	1.2%	–	Well below target and set to remain that way.
US	Jan total net TIC flows	-119.3b	–	–	Worth tracking China purchases given trade frictions.
	Feb housing starts	9.7%	-3.1%	–	Highly volatile…
	Feb building permits	5.9%	-3.6%	–	… buy to let activity key support.
	Feb industrial production	-0.1%	0.3%	–	Tracking solidly but below elevated survey indicators.
	Jan JOLTS job openings	5811	–	–	Detail on the labour market.
	Mar Uni. of Michigan sentiment	99.7	99.5	–	Consumers happy and optimistic.

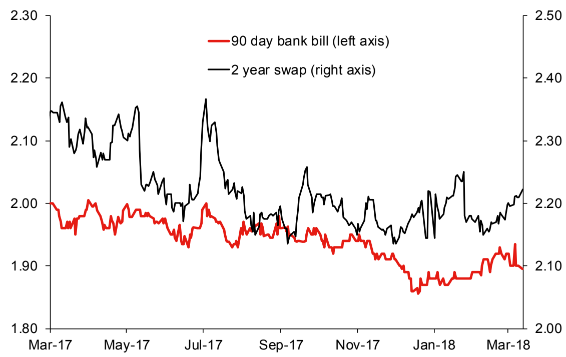
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017		2018		Calendar years			
% change	Sep(a)	Dec	Mar	Jun	2016	2017f	2018f	2019f
GDP (Production)	0.6	0.6	0.6	0.6	4.0	2.9	2.7	3.0
Employment	2.2	0.5	0.4	0.4	5.8	3.7	1.6	1.2
Unemployment Rate % s.a.	4.6	4.5	4.4	4.4	5.3	4.5	4.5	4.7
CPI	0.5	0.1	0.6	0.4	1.3	1.6	1.8	1.5
Current Account Balance % of GDP	-2.5	-2.6	-2.2	-2.4	-2.2	-2.6	-3.0	-3.3

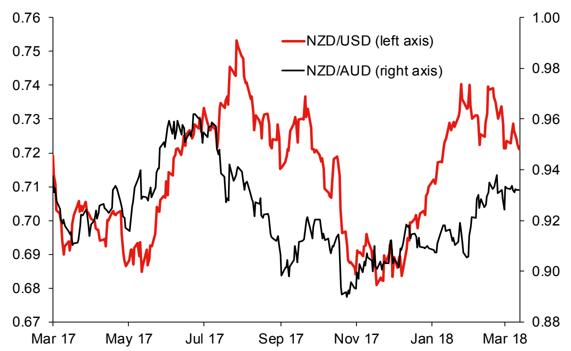
[1] Annual average % change

Financial Forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.10	2.10	2.20	2.30	2.40	2.55
5 Year Swap	2.65	2.70	2.80	2.95	3.10	3.20
10 Year Bond	2.90	3.00	3.10	3.30	3.40	3.45
NZD/USD	0.72	0.70	0.69	0.67	0.65	0.64
NZD/AUD	0.92	0.91	0.91	0.91	0.90	0.90
NZD/JPY	80.6	80.5	80.7	78.4	76.1	74.9
NZD/EUR	0.60	0.60	0.60	0.58	0.57	0.55
NZD/GBP	0.53	0.53	0.53	0.53	0.52	0.51
TWI	74.5	73.4	73.0	71.5	70.0	69.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 March 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.78%	1.79%	1.80%
60 Days	1.84%	1.87%	1.85%
90 Days	1.90%	1.99%	1.92%
2 Year Swap	2.22%	2.18%	2.15%
5 Year Swap	2.75%	2.70%	2.73%

NZ foreign currency mid-rates as at 12 March 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7295	0.7292	0.7243
NZD/EUR	0.5926	0.5934	0.5914
NZD/GBP	0.5265	0.5216	0.5243
NZD/JPY	77.91	77.94	78.82
NZD/AUD	0.9290	0.9304	0.9273
TWI	75.06	75.10	74.78

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.4	2.5	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.1	1.9
Unemployment %	6.2	5.8	5.7	5.5	5.4	5.3
Current Account % GDP	-3.0	-4.7	-2.9	-2.1	-2.3	-3.2
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	3.0	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.1	2.0
Unemployment Rate %	6.2	5.3	4.9	4.4	4.0	3.8
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.5	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.4	2.1	1.7
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.7	1.6	1.6
China						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
World						
Real GDP %yr	3.6	3.4	3.2	3.9	3.8	3.7
Forecasts finalised 14 February 2018						

Interest Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.89	1.87	1.84	1.83	1.82	1.81	1.80	1.78
10 Year Bond	2.80	2.70	2.80	2.95	3.15	3.20	3.10	3.20
International								
Fed Funds	1.375	1.625	1.875	2.125	2.125	2.375	2.625	2.625
US 10 Year Bond	2.88	2.80	2.90	3.10	3.35	3.50	3.40	3.40
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.20	0.00	0.00

Exchange Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/USD	0.7783	0.78	0.77	0.76	0.74	0.72	0.71	0.70
USD/JPY	106.72	107	109	110	111	112	111	110
EUR/USD	1.2304	1.24	1.23	1.22	1.21	1.19	1.21	1.23
AUD/NZD	1.0729	1.08	1.10	1.10	1.10	1.11	1.11	1.09

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